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March 26, 1997

William F. Caton
Secretary
Federal Communications Commission
1919 M. Street, N.W.
Washington D.C. 20554

Re: Ex Parte Contact in Dkt. Nos. 96-262; 94-1; 91-213; and 96-263

Dear Mr. Caton:

On March 25, 1997, Dr. Lee L. Selwyn and the undersigned on behalf of the Ad Hoc Telecommunications Users Committee met with representatives of the offices of Chairman Reed E. Hundt, Commissioners Rachelle B. Chong and Susan Ness, and with the Chief of the Competitive Pricing Division, to discuss the above-referenced dockets. The substance of the discussions at the meetings is reflected in the enclosure hereto, which was distributed to Commission personnel at the meetings.

Pursuant to 47 C.F.R. Section 1.1206(a)(1), two copies of this letter are being filed with the Secretary of the Commission today.

Sincerely,

James S. Blaszak

Enclosure

200/03/accessreform/LTR 326 exparte

THE ILECs' CHOICE

"Make whole" or "make money" — the ILECs must choose!

Traditional rate of return regulation ("RORR") limits ILEC earnings but guarantees the recovery of prudent investments; the competitive model expands an ILEC's earnings opportunities, but requires that it bear the full risk of its investment decisions. What the ILECs are seeking is a paradigm in which they enjoy all of the *protections* traditionally provided under RORR while retaining all of the *benefits* of a price cap system with no sharing or earnings cap. The Commission should not confer upon the ILECs this kind of asymmetry, i.e., guaranteeing their recovery of embedded costs while concurrently granting them the pricing and earnings flexibility that is enjoyed by non-regulated firms. Instead, the ILECs must be required to choose either:

- a *Make Whole* approach, in which the risks *and rewards* of ILEC investment are shifted back to ratepayers, as they were under RORR; or

- a *Make Money* approach, in which the ILECs would be required to write off the "gap" as would any non-regulated company operating in a competitive market, in exchange for the opportunity to exploit their asset base and to retain without limit any earnings that can be generated therefrom.

Each of these options is consistent with the established legal precedent that "reward follows risk and benefits follow burdens." See, *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974).

Given the choice to retain the traditional regulatory "bargain," the ILECs cannot continue to raise spurious complaints about the specter of a "taking" in violation of Fifth Amendment protections against confiscation of private property.

The ILECs have challenged on confiscation grounds the Commission's authority to require them to set rates on any basis other than embedded costs. The force of this argument can be completely overcome if the Commission allows the ILECs to choose between a "make whole" approach or a "make money" approach. Although under the "make money" approach, the ILECs will be required to set rates below embedded costs, the election is voluntary, and the alternative, "make whole" approach (under which full investment recovery would be assured) is open and available to the ILECs. Under these circumstances, the ILECs cannot argue that the Commission has compelled them to set rates at levels that they believe to be confiscatory.

The FCC has correctly recognized that the regulatory process has bestowed numerous and valuable benefits upon the ILECs — including Yellow Pages and ubiquitous cellular telephone licenses — collectively worth many multiples of the so-called "gap."

While the ILECs persist in speaking of "takings," they conveniently ignore the numerous and valuable "givings" that they have enjoyed under the current regulatory structure. These "givings" were expressly recognized in a recent speech by Chairman Reed Hundt on *Access Reform and Universal Service: Into the Thick of It.* Hundt identified many significant financial "givings" that regulators (and regulation) have bestowed upon the ILECs, including the Yellow Pages directory publishing business and cost-free licenses for cellular telephone service in every market — each of these a multi-billion dollar business. The extent of any "takings" claims must be considered in the context of these "givings" and the many other benefits of long-term incumbency.

The highly inflated claims of the ILECs regarding the level of "stranded investment" that would exist if access rates were set at forward-looking economic cost should not be accepted at face value.

ILEC claims of entitlement to recovery of so-called "stranded investment" are rooted in the theory that all of an ILEC's plant was acquired in support of its "obligation to serve" under franchise monopoly conditions. Even if one were to accept that entitlement theory, there would still be the *factual* question as to precisely *how much* of an ILEC's plant was acquired for this purpose. ILECs have not been required to obtain Section 214 preconstruction approval for more than a decade, and their capital purchases have been subject to minimal after-the-fact review since the onset of price caps. Many spending programs have been motivated by long-term strategic and competitive goals, and have been in pursuit of services and markets that, if regulated at all, are generally not regulated at the federal level. Under the mechanical operation of Parts 36 and 64, however, a significant portion of such outlays are summarily included within the interstate access services embedded revenue requirement. For this and other reasons, forward-looking economic costs associated with a specific service (e.g., switched access) frequently do not match the ILECs' embedded costs on an element-by-element basis — indeed, they can be higher *or lower.* Moreover, because it cannot be assumed that each and every asset on the ILECs' books was acquired for the provision of access or other core services, it should not be assumed that these differences add up to the whopping "stranded investment" claimed by the ILECs. The ILECs' theoretical depreciation reserve calculations are highly influenced by their strategic business goals and are not a reliable measure of stranded investment. While the USTA has estimated a theoretical reserve deficiency of $17.9-billion, AT&T's analysis shows a depreciation reserve *surplus*.

If an ILEC elects to be "made whole," the Commission should adopt a process modelled on the amortization approach adopted by the Commission for recovery of ILEC-owned inside wire, in Docket 79-105.

In the case of inside wire, ILECs were permitted to recover 12.5% of their embedded inside wire investment as of the end of 1983 in each of eight consecutive years. At the end of 1991, all inside wire investment had been written off, and ownership of those assets was transferred to the customer.

Under the "Make Whole" approach, the Commission would first need to determine the appropriate level of stranded investment for each ILEC, and the ILEC would have the opportunity to amortize 12.5% of that amount for each of eight consecutive years. During the period in which the amortization takes place, the electing ILEC would be subject to price cap regulation. The X-factor would be set by the Commission, based on the record in Docket CC 94-1, and the ILEC would be required to share and cap earnings in a manner consistent with the Commission's current price cap rule that applies when the ILEC elects the lowest (4.0%) X-factor option (50/50 sharing beginning at 100 basis points above the authorized rate of return, with an absolute earnings cap — 100% of excess earnings returned to ratepayers — at 200 basis points above the authorized ROR).

If an ILEC elects the "Make Money" alternative, then it must write-off its "stranded investment" and accept rate reinitialization, whereupon it can operate under price caps with no specific earnings limit.

The price cap LEC that elects the "Make Money" alternative should be required to first reinitialize its interstate rates at TSLRIC, and then be permitted to elect whichever X-factor and earnings option under the Commission's (then-existing) price cap rules best fits with its corporate objectives. Rate reinitialization and increases in the present range of X-factors should be adopted before the ILEC is permitted to exercise this choice.

200.03/acsrvc/accessreform/Exparte 3-25

Rate Structure Principles

In evaluating rate structure changes, the Commission should consider alleged efficiency gains in the broad sense; carefully evaluate cost-justification; and, if warranted, establish a transition plan that avoids churn and accounts for rate shock.

Commission mandated changes should be made in the correct sequence to avoid undesirable consequences for the economy as a whole and to avoid rate churn. For example, ILECs have proposed to introduce call set-up charges based upon continued inefficient use of the current switched PSTN, rather than on the costs of the most efficient forward-looking technology. Adoption of such rate structure changes could disrupt significant parts of the economy that have for many years relied on the current rate structure. The disruption could be avoided if the carriers deployed networks that are customized for data applications and call set-up charges are based on the incremental costs of such networks. The incremental costs of such networks would be far lower than the embedded costs of the current network. If, however, call set-up charges are imposed based on the embedded accounting costs of today's, major businesses will be compelled to change the manner in which they operate. If charges are subsequently lowered dramatically because rates are aligned with forward-looking economic costs, the affected businesses will be driven to change their mode of operation yet again. Rate churn is the name for this very undesirable effect. To date, ILECs have not demonstrated economic efficiencies that outweigh the cost of rate churn

Pending the development of effective competition in relevant access service markets, the Commission should protect customers through a prescriptive approach to setting access service rate structures and levels.

The Commission's Rules should ensure just and reasonable rates for customers of competitive and noncompetitive services. If pricing based on forward-looking incremental costs is appropriate for LEC services facing competition, it should also be required for non-competitive services. As long as all LEC services do not face competition and LEC costs are common to competitive and non-competitive services, the Commission must set the prices for all services based on TSLRIC or carefully regulate the allocation of LEC costs between competitive and non-competitive services. The TSLRIC of providing access service should not be materially different, if at all different, from the TELRIC of providing Unbundled Network Elements.